PRIVATIZATION: LESSONS FROM MARKET ECONOMIES

Sunita Kikeri
John Nellis
Mary Shirley

In the past decade governments all over the world have begun privatizing state enterprises—indeed, it is becoming quite hard to find a country without a program of privatization under way or at least on the policy agenda. This striking reversal of the push to expand state ownership in the 1960s and 1970s results from generally poor performance of state enterprises and a disappointing record of past reform efforts that fell short of ownership change.

This article examines the objectives of privatization and the strategies for achieving them, documenting recent trends and reviewing the experience with privatizing state-owned commercial, manufacturing, and service enterprises in both competitive and noncompetitive markets. The authors analyze the various tactics that can be or have been employed, in relation to scope, pace, sequencing, and methods of implementation. The evidence shows that privatization produces benefits of efficiency and innovation—if done right. The lessons of experience discussed in the article offer guidance on how to realize the promise of privatization while minimizing the risks and costs.

Privatization is on the rise. Since the big expansion in state ownership in the 1960s and 1970s, the number of state-owned enterprises (SOEs) worldwide has been shrinking at an accelerating pace: more than 15,000 SOEs, at a conservative estimate, have been privatized, most of them since 1990.1 Years of disappointing SOE performance and a history of halfhearted and ineffectual attempts at reform have impelled many governments, including those of Chile, the former Czechoslovakia, Germany, Mexico, and Russia, to launch privatization programs. Rhetoric still exceeds action in many countries, but a substantial number that previously depended heavily on SOEs to fulfill their development objectives—such as Zambia and just about every ex-socialist
country in Eastern and Central Europe—are now considering divesting most of their SOEs, including public utilities and enterprises formerly classified as strategic, such as airlines, ports, and railways and petrochemical, steel, cement, and even defense industries.

This article reviews the experience with privatizing state-owned commercial, manufacturing, and service enterprises, operating in both competitive and non-competitive markets, touching tangentially on the special case of privatization of banks and other financial institutions. The article is based on a wide variety of sources, including authors' field work, World Bank and International Finance Corporation (IFC) reports, a recently completed World Bank research project (Galal and others forthcoming), and external publications on privatization.

Privatization is defined here as the transfer of majority ownership of SOEs to the private sector by the sale of ongoing concerns or of assets following liquidation. Methods of privatizing management but not ownership—through management contracts, leases, and concessions—are discussed (less exhaustively) as alternatives to outright sale, but the analysis focuses on lessons derived from transfer of ownership. The article does not examine mechanisms, such as deregulation and new private sector entry, or private sector financing through “build-operate-transfer” arrangements, that are sometimes included in broader discussions of privatization.

Why Privatize? History and Evidence

At one time or another since 1945 most countries in the world have attempted to use SOEs to achieve their economic and social objectives. Developing countries typically relied more on SOEs than industrial economies did in the hope that they would balance or replace a weak or ideologically unacceptable private sector; would invest more and also produce a capital surplus to finance investment; and would transfer technology to strategic firms in mining, telecommunications, transport, and heavy industry. By the early 1980s SOEs accounted, on average, for 17 percent of gross domestic product (GDP) in Sub-Saharan Africa (in a thirteen-country sample; see Nellis 1986), 12 percent in Latin America, and a much more modest 3 percent in Asia (but this excludes China, India, and Myanmar), compared with 10 percent of GDP in mixed economies worldwide (Short 1984). In Eastern Europe and Central Asia, SOEs uniformly accounted for the bulk—as high as 90 percent—of all productive activities.

Growth and Performance of SOEs

Some SOEs performed, and still perform, well: the national electricity company in France, the major steel producer in the Republic of Korea, the airline
in Ethiopia, a publicly owned fertilizer company in Indonesia, and many SOEs
in Singapore are a few of many well-run, profitable, efficient state-owned enti-
ties. But the good performers tend to be the exceptions. Evidence from a wide
range of countries shows that many SOEs have been economically inefficient
and have incurred heavy financial losses. For example, World Bank estimates
show SOE losses between 1989 and 1991 reaching 9 percent of GDP in Argenti-
na, 8 percent in Yugoslavia, and more than 5 percent, on average, in a sample
of Sub-Saharan African countries. In Turkey the marginal efficiency of SOE
capital is half that of the private sector. Average return on capital employed
between 1985 and 1991 was 12 percent for SOEs versus 20 percent for the pri-
ivate sector. Labor productivity in 1990 was 38 percent lower in SOEs overall
than it was in the private sector. In the 1980s about half of Tanzania’s more
than 350 SOEs incurred losses that, in one year at least, put the entire sector in
deficit. In 1991 about 30 percent of all SOEs in China incurred losses, and the
consolidated government and enterprise deficit was in the range of 8 percent
of GDP (McKinnon 1994; Yusuf and Hua 1992).

In some countries, SOEs have become an unsustainable burden on the budget
and the banking system, absorbing scarce public resources. Government trans-
fers and subsidies to SOEs amounted to more than 3 percent of GDP in Mexico
in 1982, 4 percent of gross national product (GNP) in Turkey in 1990, and 9
percent of GDP in Poland, according to World Bank estimates. In Ghana the
annual average outflow from government to fourteen core SOEs in the late
1980s consistently exceeded the meager inflows—in the form of dividends and
taxes—from the firms to the state. Arguably, these transfers and subsidies do
not matter if the money spent alleviates a market failure or lays the base for
future returns, but in some instances the costs of SOEs may exceed the costs of
market failures, while investments in SOEs have not consistently produced cost-
covering streams of income. The financial performance of nine key SOEs (tele-
communications, postal services, airlines, railways, transport, power, cement,
iron and steel, and textiles) in five West African countries (Benin, Ghana, Guin-
ea, Nigeria, and Senegal) has been persistently poor, with annual government
transfers and overdrafts to these sectors ranging from 8 to 14 percent of GDP,
an indication that earlier efforts to reform these sectors have failed. Recent
World Bank reviews of power and telecommunications sectors found steady
deteriorations in the performance of many SOEs since the 1970s (World Bank
1993; Wellenius and others 1989; and Ambrose, Hennemeyer, and Chapon
1990).

The problem is not simply that SOEs have yielded a disappointing rate of
return on the capital invested in them. Overextended and poorly performing
SOEs have also slowed the growth of the private sector in many developing
countries. How does this happen? First, our field studies found that govern-
ments often block the entry of private firms that would compete with SOEs.
For example, Peruvian legislation at one time prohibited private firms from
producing their own electricity, forcing them to buy from the often unreliable

Sunita Kikeri, John Nellis, and Mary Shirley

243
public grid. Niger gave a state distribution company a monopoly on many food imports; when it was lifted, there was a rush of new private entrants—despite falling prices. In India entire sectors and subsectors of industry (energy, shipyards, nonferrous metals, telecommunications equipment, mining, and steel plants) were statutory monopolies in 1988, reserved for SOEs.

Second, government credit directed to capital-intensive SOEs often crowds private firms out of credit markets. Before privatization and reform in Guinea, SOEs—which contributed only 25 percent of GDP—absorbed 90 percent of formal credit from domestic banks. This imbalance might merely reflect the more capital-intensive character of state enterprises, but in fact the credit is often allocated by government directive and used to cover current account deficits. Some banking systems in developing countries are now insolvent because of the nonperforming debt of state enterprises.

Third, even when government eliminates explicit guarantees for credit taken on by SOEs, bankers tend to assume that there is an implicit government guarantee, a perception that affects their lending, to the disadvantage of the private sector. For example, in Russia, the rapidly growing private sector is finding it hard to obtain access to financing because credit allocation is still dominated by directed state credits to SOEs. And fourth, inefficient provision of critical inputs by badly managed public utilities has increased the costs of business to private firms and limited the potential for expansion, particularly for smaller firms (World Bank 1991).

Still, even if one accepts the view that SOEs, on average, function poorly and impede private sector development, is privatization the solution? Or can the deficiencies of SOEs be remedied without changing ownership? In theory a state-owned firm should operate as efficiently as a private firm, if both function in a competitive market setting and if their behavior is governed by the same rules and incentives; and in fact, comparison of the performance of public with private enterprises (mostly based on experience in industrial countries) has not consistently provided compelling evidence that ownership matters. Many analysts have concluded that competition and regulation are more important than ownership in determining economic performance (Vickers and Yarrow 1988; Hemming and Mansoor 1988), and that therefore policymakers should focus primarily on making markets work well. (It is less often acknowledged that well-functioning markets eliminate much of the justification for government ownership.) A common operational interpretation of this reasoning is that governments should privatize only if markets function reasonably well and there are no significant market failures. But much experience of the past two decades shows that, in practice, markets and public ownership are linked in ways that can reduce competition, even without a significant market failure.

To illustrate: because losses from state enterprises can affect the public budget and debt, governments often intervene to protect high-cost SOEs from competition, to give them subsidies or privileged access to finance, or otherwise to tilt what should be a level playing field. To the extent that the high costs of
SOEs are the result of burdens imposed by government (which is often the case), this sense of obligation to protect them from competition is intensified. These burdens may be social (maintaining employment or developing backward regions), political (providing jobs and power to certain groups), or rent-seeking in nature. In this way state ownership, created to overcome or correct market failure, can sometimes aggravate or perpetuate it.

In such cases privatization could well be used to enhance competition because it reduces the government’s direct stake in protecting particular industries. The odds of succeeding are much improved when privatization is part of a more general liberalization process: in other words, when privatization is not delayed in the (often unfounded) hope that government will construct a well-functioning market but is used to help create that market through enlarging the number of actors who have a direct stake in seeing markets work well. This role for privatization is regarded as crucial by Czech reformers, who consider privatization’s principal function to be “opening economic space”; privatization also served this purpose in Chile and Mexico, where it was treated as an integral part of a broader liberalization program. In addition privatization and the closely associated process of liquidation may eliminate a government failure more costly to economic welfare than the market failure that the SOE was created to correct (as appears to have happened in some of the liquidations and sales in Guinea; see Suzuki 1991).

Moreover, recent evidence shows gains from privatization even if market structures do not change. Chile offers a striking example. Infrastructure monopolies in electricity generation and distribution and in telecommunications were efficiently run and effectively regulated as SOEs. Their privatization nonetheless produced substantial welfare gains, primarily because private owners overcame a constraint on investment that the government had imposed on the SOEs, and secondarily because the new private management operated the companies more efficiently (Galal and others forthcoming).

Finally, a focus on market failures alone ignores the findings from principal-agent literature, which imply that a change in ownership per se can affect economic performance, all other things being equal. By reducing the number of principals to a single owner whose one overriding objective is to maximize profits, privatization greatly simplifies the principal-agent problem and creates the potential for efficiency gains. In the Chilean case cited above, the profit-maximizing private owners responded to excess demand with new investment. In contrast, government’s diverse principals with multiple objectives had long regarded investment in telecommunications as low priority and would have been unlikely to make the investment if the enterprise had remained public.3

Efforts at Reform

In the past twenty years most countries in which SOEs were major economic and social actors—including most developing countries—have adopted reform
programs, short of ownership transfer, to try to rectify the causes of poor SOE performance. These reforms aimed to expose SOEs to domestic and external competition and level the playing field by eliminating easy access to credit from the budget and banking system; by freeing managers of SOEs from noncommercial goals and government interference in day-to-day decisionmaking; and by developing institutional mechanisms, such as contract plans and performance evaluation systems, to hold managers accountable for results.

In response to these reforms, some SOEs have indeed performed better (see Galal 1991; Shirley and Nellis 1991). But two related problems persist. First, the reforms are technically and politically difficult to implement. Often, well-designed programs have fallen short in implementation. Second, performance does improve when the full reform package is put in place, but the necessary steps are numerous and hard to coordinate, and entire reform programs have seldom been enacted. For instance, governments often discontinue budget support but continue to guarantee borrowing from the banking sector, and pay and employment reforms have yielded little without increased managerial autonomy and accountability.

Both these problems could apply equally to privatization, which also requires technical competence, political will, and comprehensiveness. But a third and more important problem of SOE reform is sustainability. Improvements in SOE performance, unlike those arising out of privatization, are relatively easy to reverse, whether in industrial countries such as Japan and New Zealand or in developing countries. In Senegal, for example, SOE performance overall has remained poor, despite reforms dating back to 1977. The effect of a slight financial improvement achieved in the early 1980s soon dissipated, and total losses have continued to climb. The Senegalese SOEs that signed contracts pledging better performance (in return for greater autonomy) did perform better than those without contracts, but the device failed to impose crucial financial discipline. Although far from valueless, the performance contract has proved an inadequate—because unenduring—tool in many other countries (see Nellis 1989).

The Senegalese case illustrates the common problem: faced with a financial crisis or pushed by external forces, governments will initiate fundamental and far-reaching reforms in SOEs that give management the mandate and the power to run their companies in a commercial manner. As the reforms are enacted, economic and financial performance does improve—although usually at the expense of some previously highly regarded political objectives. As the crisis fades, however, or the external pressure weakens, government ownership facilitates the revival of noncommercial objectives, which in turn often leads to renewed poor performance. So performance of SOEs can be improved without changing ownership, but these improvements are exceedingly difficult to sustain.

Our investigations found that several SOEs, judged in the World Bank's World Development Report 1983 to be well on the road to enduring performance improvements thanks to exemplary government reform efforts (fertilizer SOEs in Turkey, manufacturing SOEs in Pakistan, and the Senegalese bus
company), either have not improved as expected or have even substantially deteriorated. Bangladesh, for example, attempted to reform industrial SOEs in the 1980s by increasing managerial autonomy, restructuring the enterprises, and undertaking employment and wage changes. Yet, SOE performance deteriorated throughout the reform period, and net transfers from the state to SOEs increased from 0.8 percent of GDP in 1986 to 3.2 percent of GDP in 1989.

China launched a restructuring program in the 1980s to stem losses and improve the efficiency of SOEs by introducing bankruptcy legislation and competition from nonstate enterprise. The reforms led to rapidly growing private, "collective," and town and village enterprise sectors (the share of national SOEs in industrial production dropped from close to 70 percent in 1986 to 53 percent in 1990), and the introduction of a "production responsibility system" improved performance in at least some industrial SOEs. Total factor productivity for SOEs rose at a respectable 3 percent a year between 1984 and 1988 (although this was well below the 6 percent rate of nonstate enterprises). Nonetheless, close to 30 percent of all SOEs still incur losses that absorb a sixth of the government's budgetary expenditures; such losses rose substantially between 1987 and 1990 (Yusuf and Hua 1992).

The Turn toward Privatization

The high costs and poor performance of SOEs and the modest and fleeting results of reform efforts have turned many governments toward privatization. Other reasons include shifting development theory and ideologies in the face of mounting SOE losses, the collapse of communism in Eastern Europe and the Soviet Union, and some successes of early privatizers such as the United Kingdom. Fiscal crises have also led some governments to privatize as a way to raise revenues and stem losses, especially in the face of increasing public debt. More governments have opted for privatization because of their inability to finance needed investment in their SOEs than because of their expectations of efficiency gains. Finally, some of the initial reasons for state ownership have disappeared. Technology and growth have introduced competition into traditionally monopolistic activities such as telecommunications or the generation of electricity; the emergence of a dynamic private sector has weakened the argument that state ownership is needed as a substitute for frail or nonexistent domestic entrepreneurship in many developing countries; and increasing capacity of governments, at least in the middle-income developing countries, to curb the excesses of multinational companies has weakened the case for SOEs as defenders of sovereignty.

Between 1980 and 1992 more than 15,000 enterprises were privatized worldwide (figure 1), more than 11,000 of these in the former East Germany. Among the more than 3,800 sales in countries that borrow from the World Bank, the former socialist economies in Eastern Europe and Central Asia and countries in Latin America together account for 85 percent (figure 2).
Privatization has substantially reduced the size of the SOE sector in several countries. Between 1984 and 1990 Mexico privatized more than 20 percent of total SOE assets by selling or liquidating more than 400 of its 1,155 SOEs (in telecommunications, airlines, sugar, mining, manufacturing, banking, and other services) and merging or transferring to municipalities a further 400. It has continued the divestiture process in the 1990s. Chile, in privatizing all but 23 of its 524 SOEs since 1973, reduced state ownership of producing assets from 39 percent of GDP in 1973 to 12 percent in 1989. Argentina and Venezuela significantly downsized their SOE sectors by selling their telephone companies and airlines. They are now privatizing other utilities and large industrial SOEs, and Argentina in particular is well on its way to eliminating virtually all of its SOE sector, including industries under the Ministry of Defense (Alexander and Corti 1993).

But in most developing countries, particularly the low-income countries, the change has been modest. Most often it is the small, low-value firms in industry and services that have been sold. In Guinea, for example, seventy of ninety-eight privatizations carried out in the mid-1980s dealt with virtually defunct retail outlets and small, nonoperating enterprises. Tunisia partially or fully privatized thirty-nine SOEs between 1988 and 1992; in every case the firm divested was a small, usually money-losing operation, functioning in a competitive market. The revenue generated by all thirty-nine sales equaled slightly
more than 1 percent of the SOE sector's 1987 book value (authors' field work). This emphasis on the small is changing; in the past five years alone, thirty-five very large SOEs with a combined sales value of more than $22 billion have been privatized in fourteen developing countries (table 1).

_The Impact of Privatization_

As noted, economists and others have long been concerned with the relationship between ownership and efficiency. The 1970s and the early 1980s witnessed an outpouring of articles and studies comparing the efficiency of similar types of production or service under private and public ownership (Borcherd- ing, Pommerehne, and Scheider 1982; Domberger and Piggott 1986; see also Yarrow 1988, p. 374, table a.1 for a listing of empirical studies). Most of the cases were drawn from industrial countries and focused on municipal services, airlines and other transport services, electric utilities, insurance, hospitals, and housing. The studies were partial, in that they concentrated mostly on costs. Most found that private production was indeed cheaper than public, but they tended to conclude—as one study put it—that "it is not so much the difference in . . . ownership but the lack of competition which leads to the often observed
Table 1. Recent Privatization Transactions Valued at US$100 Million or more, 1988–92

<table>
<thead>
<tr>
<th>Economy</th>
<th>Enterprise</th>
<th>Date of sale</th>
<th>Gross transaction value (millions of US$)</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>Bancomer</td>
<td>10/91</td>
<td>2,550</td>
<td>Banking</td>
</tr>
<tr>
<td>Mexico</td>
<td>Bancamex</td>
<td>9/91</td>
<td>2,300</td>
<td>Banking</td>
</tr>
<tr>
<td>Korea, Republic of</td>
<td>Korea Electric Power</td>
<td>6/89</td>
<td>2,100</td>
<td>Power</td>
</tr>
<tr>
<td>Venezuela</td>
<td>CANTV</td>
<td>11/90</td>
<td>1,885</td>
<td>Telecommunications</td>
</tr>
<tr>
<td>Mexico</td>
<td>TELMEX</td>
<td>12/90</td>
<td>1,760</td>
<td>Telecommunications</td>
</tr>
<tr>
<td>Brazil</td>
<td>Usiminas</td>
<td>12/91</td>
<td>1,430</td>
<td>Steel</td>
</tr>
<tr>
<td>Mexico</td>
<td>Mexicana de Cobre</td>
<td>10/88</td>
<td>1,360</td>
<td>Mining</td>
</tr>
<tr>
<td>Argentina</td>
<td>ENTEL</td>
<td>11/90</td>
<td>1,244</td>
<td>Telecommunications</td>
</tr>
<tr>
<td>Mexico</td>
<td>Banca Serfin</td>
<td>1/92</td>
<td>909</td>
<td>Banking</td>
</tr>
<tr>
<td>Mexico</td>
<td>Multibanco Comermex</td>
<td>2/92</td>
<td>872</td>
<td>Banking</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Telekom Malaysia</td>
<td>10/90</td>
<td>861</td>
<td>Telecommunications</td>
</tr>
<tr>
<td>Brazil</td>
<td>Copesul</td>
<td>5/92</td>
<td>839</td>
<td>Petrochemical</td>
</tr>
<tr>
<td>Mexico</td>
<td>Cananea</td>
<td>9/90</td>
<td>475</td>
<td>Mining</td>
</tr>
<tr>
<td>Argentina</td>
<td>Somisa</td>
<td>10/92</td>
<td>404</td>
<td>Steel</td>
</tr>
<tr>
<td>Philippines</td>
<td>Philippines Airlines</td>
<td>1/92</td>
<td>368</td>
<td>Airline</td>
</tr>
<tr>
<td>Mexico</td>
<td>Aerovias de México</td>
<td>11/88</td>
<td>339</td>
<td>Airline</td>
</tr>
<tr>
<td>Philippines</td>
<td>Nonoc</td>
<td>10/90</td>
<td>325</td>
<td>Mining</td>
</tr>
<tr>
<td>Taiwan (China)</td>
<td>China Steel</td>
<td>4/89</td>
<td>285</td>
<td>Steel</td>
</tr>
<tr>
<td>Argentina</td>
<td>Aerolinas Argentinas</td>
<td>4/90</td>
<td>285</td>
<td>Airline</td>
</tr>
<tr>
<td>Mexico</td>
<td>Banca Cremi</td>
<td>6/91</td>
<td>248</td>
<td>Banking</td>
</tr>
<tr>
<td>Mexico</td>
<td>Multibanco de Mercantil</td>
<td>6/91</td>
<td>204</td>
<td>Banking</td>
</tr>
<tr>
<td>Mexico</td>
<td>Banpais</td>
<td>6/91</td>
<td>182</td>
<td>Banking</td>
</tr>
<tr>
<td>Mexico</td>
<td>Sicartsa 1</td>
<td>11/91</td>
<td>170</td>
<td>Steel</td>
</tr>
<tr>
<td>Chile</td>
<td>Compañía de Teléfonos</td>
<td>1/88</td>
<td>170</td>
<td>Telecommunications</td>
</tr>
<tr>
<td>Mexico</td>
<td>Sidermex North</td>
<td>11/91</td>
<td>145</td>
<td>Steel</td>
</tr>
<tr>
<td>Venezuela</td>
<td>VIASA</td>
<td>9/91</td>
<td>145</td>
<td>Airline</td>
</tr>
<tr>
<td>Mexico</td>
<td>Mexicana de Aviacion</td>
<td>6/89</td>
<td>140</td>
<td>Airline</td>
</tr>
<tr>
<td>Brazil</td>
<td>Aracruz</td>
<td>5/88</td>
<td>130</td>
<td>Pulp and paper</td>
</tr>
<tr>
<td>Turkey</td>
<td>Pertim</td>
<td>6/90</td>
<td>125</td>
<td>Petrochemical</td>
</tr>
<tr>
<td>Peru</td>
<td>Hierro Peru</td>
<td>12/92</td>
<td>120</td>
<td>Mining</td>
</tr>
<tr>
<td>Poland</td>
<td>Kwidryn</td>
<td>8/92</td>
<td>120</td>
<td>Pulp and paper</td>
</tr>
<tr>
<td>Hungary</td>
<td>Tungsram</td>
<td>5/89</td>
<td>110</td>
<td>Electric equipment</td>
</tr>
<tr>
<td>Mexico</td>
<td>Nikko Hotel</td>
<td>10/88</td>
<td>110</td>
<td>Hotel</td>
</tr>
<tr>
<td>Mexico</td>
<td>Tereftaltos Mexicanos</td>
<td>1/88</td>
<td>106</td>
<td>Chemical</td>
</tr>
<tr>
<td>Colombia</td>
<td>Papelco</td>
<td>8/90</td>
<td>100</td>
<td>Pulp and paper</td>
</tr>
</tbody>
</table>

Source: Privatisation International Yearbook and World Bank data.

less efficient production in public firms.” This study reasoned that “given sufficient competition between public and private producers (and no discriminative regulations and subsidies), the differences in unit cost turn out to be insignificant” (Borcherding, Pommerehne, and Scheider 1982: 136).

As of the late 1980s few attempts to examine the difference between public and private production had been undertaken in developing countries. A study comparing the performance of fifty-three public and twenty-four private
Tunisian enterprises (in similar sectors) found that the productive efficiency of public enterprises was not detectably different from that of private firms (Svejnar and Hariga forthcoming). A survey of the scant material from cases in developing countries offered a guarded conclusion: “There is no evidence of a statistically significant kind to suggest that public enterprises in LDCs have a lower level of technical efficiency than private firms operating at the same scale of operation. [But] on a less formal level the tendency . . . seems to be pointing in that direction” (Millward 1988: 157).

Thus, past studies undertaken in industrial economies largely attributed superior efficiency in private over public firms to market structure rather than to ownership, while the few studies of developing countries revealed marginal efficiency differences between public and private firms. However, more recent evidence, which compares SOE performance before and after privatization, shows considerable economic benefits resulting from properly structured privatization, even when the privatized firms were monopolies.

A recent World Bank research project, in contrast to earlier partial studies, examined the effects of divestiture on all important actors. It also assessed the long-run impact of privatization by isolating its effects on firm behavior from concurrent changes (such as changes in macroeconomic policy, technology, demand structure, or the regulatory framework) and answering the counterfactual—what would have happened to performance if ownership had not changed? The study found that privatization significantly improved domestic and international welfare in eleven of twelve divestitures analyzed, where nine of the twelve were noncompetitive (Galal and others forthcoming). Productivity rose in nine cases and stayed the same in the other three. Relaxation of the investment constraint and diversification into previously forbidden products and markets resulted in massive expansion in most cases. Workers as a class were judged to be no worse off after sale (layoffs did occur, but affected workers received generous compensation) and in three cases were significantly better off (thanks especially to share purchase schemes for workers who retained their jobs). Buyers most often made money, but the other stakeholders also gained in the process. In most cases consumers benefited or were no worse off.

Other studies, less rigorous but with broader coverage, also found improvements after privatization. A study of forty-one firms fully or partially privatized between 1981 and 1989 by public share offerings in fifteen countries (primarily industrial, but including Chile, Jamaica, and Mexico) found substantial efficiency gains (Megginson, Nash, and van Randenborgh 1992). The privatized firms increased returns on sales, assets, and equity; raised internal efficiency; improved their capital structure; increased investments; and marginally increased their work forces as a result of faster growth. In some other cases—for example, Argentina, Chile, Niger, and Tunisia—dynamic expansion and investment in modernization by the new owners raised employment levels in several of the firms investigated (authors’ field studies). Similar results were found in an analysis of sixty-two privatized petrochemical and auto parts firms.
in Mexico, where privatization also helped reduce management numbers but allowed the remaining managers to be paid at more competitive rates (Perez Escamilla 1988).

Most clear-cut success stories come from high- or middle-income countries. The privatization process is harder to launch in least developed settings, and the chances of failure are greater. Still, positive results have been obtained. In Bangladesh privatized textile companies were more profitable than public textile mills. This was partly attributable to debt write-offs, but greater attention to cost containment and more aggressive marketing also helped (Lorch 1988). Privatization revived a near-dead textile company in Niger, which now operates profitably at close to full capacity with a larger work force; the company exports much of its production and has won a large domestic market share against imports (authors’ field study). In Swaziland a development finance corporation, which had been closed before sale, became profitable in its second year of private ownership; a privatized agro-industrial SOE in Mozambique diversified its products, began servicing its debts, and increased production five-fold (IFC field studies). Evidently, privatization can yield positive results even in difficult settings.

Revenues from some sales have been large; gross proceeds from the sale of about 700 SOEs in five Latin American countries exceeded $18.3 billion during the past ten years, or 8 percent of their total outstanding foreign debt as of 1990 (authors’ estimates). But net revenues have often been modest or even negative because of the small size of transactions and the need to pay debt, delinquent taxes, and transaction fees from the proceeds—and because many sales have been on credit.

Privatization in many cases has reduced the overall financial burden of SOEs and at the same time has increased government income, because taxes paid by privatized firms have sometimes exceeded those taxes or dividends previously paid by SOEs. In Mexico government transfers and subsidies to SOEs declined by 50 percent between 1982 and 1988; the stabilization program after the 1982 shock was certainly the most important cause, but privatizations helped lock in these reductions. In a particularly dramatic case, Malaysia sold a sports lottery in 1985; by 1989 revenues from levies on the privatized lottery were three times greater (in real terms) than revenue from the former SOE (Galal and others forthcoming). In Chile the net annual flow of funds from the electricity distribution company ENERSIS declined after privatization because the government no longer received dividends, but taxes increased as performance gradually improved (Galal and others forthcoming).

Consumers can gain from privatization. The World Bank research project cited above (Galal and others forthcoming) found that, quite apart from any benefits from improved service, consumers for the most part gained or remained unaffected by privatization. In the five instances in which consumers did lose, the (generally small) losses were attributable mostly to prices moving closer to their scarcity values. The study concluded, for example, that consum-
ers in Chile were unaffected by the sale of ENERSIS; paying consumers were better off, but this gain was balanced by losses to those who had hitherto been getting the service free through illegal connections. (If only those who had previously been paying had been considered legitimate consumers, the findings would have shown substantial increases in consumer welfare.) In the aggregate, telecommunications consumers in the United Kingdom are better off. Consumers of long-distance service did better in all years, while the position of consumers of local and other services remained more or less unchanged. Increased competition and technological changes played a part, but new managers with full operational autonomy and an effective regulatory framework also made a difference. The quality of service deteriorated in the early years after privatization (partly because of increased demand), but subsequent improvements now make the service better than it was before privatization.

Privatization Objectives and Strategy

Once a government has decided to privatize, how should it go about the process? Rapidly accumulating experience offers several lessons.

Defining Objectives

*Enhancing efficiency should be the primary goal.* Governments may feel pressure to design privatization programs to minimize losers and maximize winners or to maximize revenues so that losers can be compensated. But designing programs instead to maximize efficiency, although politically more difficult, will bring to the economy more sustained gains, which can then be distributed to potential losers. Privatization does the most good when it is used to increase competition and prevent monopolistic behavior. The high risks in developing countries often lead prospective investors to argue for special privileges and protection in exchange for private investment, but this can lead to perverse results. A steel mill in Togo, for example, was leased to a private owner but continued to enjoy heavy protection. Although the leaseholder made money, overall economic welfare suffered. The correct economic decision would have been to liquidate the steel mill, but the government feared the political consequences of closure. Opportunities for competition exist even in sectors once regarded as naturally monopolistic. For example, the water and electricity generation companies in the United Kingdom were divided into ten and sixteen smaller units, respectively, before being sold. The companies compete directly, and the performance of a water company in one geographical area can be compared with those in other regions to encourage "yardstick competition," under which performance indexes are collected, adjusted for regional differences, and then compared. A company whose performance falls below its historical position in relation to the average might risk losing its franchise.

Sunita Kikeri, John Nellis, and Mary Shirley
Maximizing short-term government revenues should not be the primary consideration. Selling SOEs as monopolies to maximize the selling price can be good for the budget but bad for the economy. In privatizing infrastructure SOEs, a monopoly concession in some activities may be unavoidable because of economies of scale. But society will benefit if the government first deregulates and establishes adequate tariff regulation, and then privatizes—even if that means a lower sale price. To maximize the selling price and short-term revenue to government, Jamaica appears to have given away too much in the transaction, granting its privatized telephone company a twenty-five-year concession on local and competitive international services that guaranteed a rate of return exceeding industry norms and providing few incentives to reduce costs. By contrast, other telecommunications privatizations in the region have entailed both shorter monopoly periods and lower rates of return. In the recent telecommunications sales in Argentina, Mexico, and Venezuela, nonbasic services were opened up to varying levels of competition. Private purchasers obtained seven-to ten-year concessions in local services, but the deals were combined with incentives to encourage expansion and reduce costs. For example, in Mexico the privatized TELMEX pays a corporate tax rate of 10 percent if it meets the promised investment schedule; 29 percent if it does not. In this instance, as in many other infrastructure sales, greater weight was given to follow-on investments than to price.

Privatization has been used successfully to develop capital markets in Chile, France, Jamaica, Japan, Nigeria, and the United Kingdom (table 2). Yet, overemphasizing its role in developing capital markets can cause problems. Weak

### Table 2. Privatization and Capital Market Development

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of enterprises sold through stock exchange</th>
<th>Proceeds of sale through stock exchange (millions of US$)</th>
<th>Proceeds as a percentage of stock market capitalization</th>
<th>Number of new shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada&lt;sup&gt;c&lt;/sup&gt;</td>
<td>2</td>
<td>812</td>
<td>0.4</td>
<td>n.a.</td>
</tr>
<tr>
<td>Chile (since 1985)</td>
<td>14</td>
<td>894</td>
<td>9.3</td>
<td>63,316&lt;sup&gt;d&lt;/sup&gt;</td>
</tr>
<tr>
<td>France</td>
<td>14</td>
<td>5,148</td>
<td>3.0</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Jamaica</td>
<td>3</td>
<td>121</td>
<td>12.6</td>
<td>30,000</td>
</tr>
<tr>
<td>Japan</td>
<td>1</td>
<td>75,600</td>
<td>1.7</td>
<td>1,670,000</td>
</tr>
<tr>
<td>Nigeria</td>
<td>16</td>
<td>27</td>
<td>2.0</td>
<td>400,000</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>2</td>
<td>7</td>
<td>2.5</td>
<td>n.a.</td>
</tr>
<tr>
<td>Tunisia</td>
<td>2</td>
<td>9</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>14</td>
<td>51,721</td>
<td>n.a.</td>
<td>7,400,000</td>
</tr>
</tbody>
</table>

n.a. Not available.

a. Includes share auctions and public offerings.
b. Market capitalization in year of last public offering.
c. Includes only federal ("Crown") enterprises.
d. Does not include shareholders in ENDESA.

absorptive capacity creates delays and crowds out new private share issues; the
sale of 24 percent of Telekom Malaysia in September 1990, for example, aimed
to raise M$2.35 billion—nearly as much as the M$3 billion the Kuala Lumpur
stock exchange had raised in total in 1989. Selling poorly performing enter-
prises without adequate information and prudential regulation may exploit
small, first-time investors, end up in government bailouts, or undermine the
credibility of future sales. In most developing countries the kind of preparation
poorly performing SOEs need for their shares to sell on the stock market re-
quires time and resources better spent on activities benefiting a larger part of
society. Finally, capital market transactions involve potentially large pricing
discounts (see below) that can result in a political backlash.

Short-run distributional goals, although they cannot be ignored, should not be
pursued at the cost of managerial competence. Many governments (Chile, France,
Jamaica, Nigeria, and the United Kingdom, for example) see wide distribution
of shares as an important objective of privatization, even though share owner-
ship tends to reconcentrate over time.6 But dispersed ownership may come at
the expense of management performance. In mature stock markets, the threat
of corporate takeovers and bankruptcy, influential financial journalism, and the
active participation of nonexecutive directors can to some extent provide man-
agement discipline. Most developing countries lack these, and the managements
and corporate governance of most SOEs are usually in need of a shakeup.

One way both to improve corporate governance and to spread ownership is
to reserve core shareholdings (at least temporarily) for strategic investors with
a significant stake in the company, as has been done in Chile and France and
in a few innovative privatizations in Tunisia. Skilled owners or investors are
thus placed in charge of the assets, although this tactic could create entrenched
interests. In all twenty-eight of the privatizations conducted between December
1989 and May 1993 in Sri Lanka, a majority shareholding was sold on tender
to a corporate investor, 10 percent was gifted to the employees of the privatized
company, and 30 percent was reserved for subsequent sale to the public
through the stock exchange (as of May 1993, nine public offerings had been
concluded, and another six were in process; see Jayasinghe 1993). When priva-
tizing state-owned banks, the governments of Mexico and Venezuela attempted
to resolve the potential problem of entrenched interests by giving incentives to
core investors, but requiring them to divest a portion of their shares to the pub-
lic and employees after an initial period.

Another solution is to involve institutional investors—life insurance, pen-
sion, and provident funds—where trade buyers are absent. Although they tend
to be more passive than trade owners, often exerting limited influence in direct
corporate governance, institutional investors are preferable to a large number
of dispersed shareholders precisely because of their size. Because institutional
investors are large, they have economies of scale in collecting information on
companies, and their decisions to sell or buy can affect share prices. Thus, they
are more informed than individual investors and have more incentive to
monitor performance and keep management up to the mark—and management has more incentive to listen. Private pension funds in Chile do this well: they now hold more than half of all the corporate bonds issued by privatized companies and a significant percentage of their equity as well. Findings of research on the effects of institutional investors are, however, ambiguous: some studies, for instance, argue that the ease with which institutional investors can move their shares from firm to firm leads them to focus on short-term profits (see, for example, Black 1992; Porter 1992).

Conditions for Success

Two factors are paramount in determining the strategy and influencing the outcomes of privatization for economic productivity and consumer welfare. The first is country conditions, in particular the extent to which free entry is allowed by the macroeconomic and regulatory policy framework, markets are competitive, resources are allocated on the basis of marginal returns, and the regulatory and supervisory institutions are effective. The second is the nature of the market into which the enterprise is divested, that is, whether the market is competitive or potentially competitive as opposed to noncompetitive (see table 3). (A potentially competitive market is defined as one in which relaxation of legal or regulatory barriers to entry would reasonably be expected to produce, in the short to medium term, either domestic or foreign competitors.)

COUNTRY CONDITIONS. Privatization of both competitive and noncompetitive SOEs is easier to launch and more likely to yield financial and economic benefits in countries that encourage entry and free trade, offer a stable climate for

<table>
<thead>
<tr>
<th>Country conditions</th>
<th>Enterprise conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Competitive</td>
</tr>
<tr>
<td>High capacity to regulate; market friendly</td>
<td>Decision</td>
</tr>
<tr>
<td></td>
<td>• Sell</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Low capacity to regulate; market unfriendly</td>
<td>Decision</td>
</tr>
<tr>
<td></td>
<td>• Sell, with attention to competitive conditions</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 3. Privatization: A Framework for Decisionmaking

256

The World Bank Research Observer, vol. 9, no. 2 (July 1994)
investment, and have a relatively well-developed institutional and regulatory capacity. The advantages of creating the right policy and institutional framework are illustrated by successful privatizers such as Chile and Mexico, which began macroeconomic and public sector reforms well before privatization. Chile, for example, reduced tariffs to 10 percent across the board, eliminated its budget deficit through tax reforms and expenditure cutbacks, and introduced a stabilization program that reduced inflation from 380 percent in 1974 to 38 percent in 1979 (Corbo 1993). Such reforms attract private investors and ensure that privatization expands competition and productive efficiency, rather than simply transferring rents from SOEs to private owners.

In low-income countries, privatization of both competitive and noncompetitive SOEs is a challenge. In addition to the usual social and political obstacles, such countries often face macroeconomic distortions; thin capital markets; limited interest from foreign investors; and weak legal, regulatory, and institutional capacity. Poorly conceived and badly managed privatization in such settings has compounded the problem. Terms and conditions of sale granting excessive sweeteners such as new monopoly rights or overly generous tax and duty exemptions, have reduced competition and efficiency, as in Guinea, for example (see Suzuki 1991). In other instances, privatized enterprises have gone bankrupt, although closures do not necessarily indicate that the policy of privatization is misguided. Many of these firms had not been viable when they were state owned but had been kept alive by government protection and subsidies. Few developing countries can afford to subsidize, at the expense of all of their citizens, the relatively small number of people in unproductive SOE jobs. The demise of loss-making firms (public or private) can free assets for more productive use, eliminate a burden on the economy, and allow investments and job creation elsewhere.

The distributional effects of privatization in low-income countries are yet to be thoroughly analyzed, but a concentration of assets in the hands of a small elite is a legitimate concern. Sales without competitive bidding, at predetermined concessionary prices or into protected markets, have helped enrich small groups of well-connected individuals. The examples cited earlier show that privatization in low-income countries can yield significant economic gains in those (unfortunately few) cases where it is well managed, but the fact remains that the weaker the economy and the governing institutions, the more difficult it will be for privatization to yield benefits.

Market conditions. Privatizing enterprises that produce tradables—in competitive or potentially competitive sectors such as industry, agriculture, and retail operations—is easier because regulation is not required. If privatization also expands competition—a likely outcome because, for reasons cited earlier, governments find it hard to maintain a level playing field for their SOEs—then solid and rapid economic benefits will result (as long as there are no economy-wide distortions that hinder competition). In countries where markets prevent
monopolistic behavior and provide incentives for efficiency, successful privatization may require little more than adequate attention to transparency. Even in countries where markets are weak, privatization may still be beneficial if it reduces the fiscal burden of SOE subsidies and exposes fully the costs of the distortions. In such circumstances, rapid privatization of competitive firms, accompanied by liberalized trade and prices and strengthened institutional and regulatory framework, should be feasible.

Privatizing SOEs that operate as monopolies, such as power, water, or telecommunications, is harder in any setting: the enterprises are larger, the stakes higher, foreign investment issues more sensitive, and regulatory questions more salient. Nonetheless, the research cited above shows that privatizing such enterprises has yielded benefits in Chile, Mexico, and the United Kingdom (Galal and others forthcoming). A regulatory framework that sets out the tariff regime, establishes goals for universal service, develops targets for minimizing costs, and has credible regulatory institutions that can supervise the established procedures and resolve conflicts is essential to clarify the rules of the game and create a stable and predictable operating environment for private investors. Such a framework also helps allay fears about equity and political opposition, allowing decisionmakers to erect mechanisms to defend transparency, competition, and the public interest. Chile’s well-developed regulatory framework ensured that sale of its power companies increased efficiency without harming consumer interests. Tariffs were structured so that large consumers with high demand at peak periods, who cause the system to expand, would pay a higher price than consumers who do not cause this expansion; these would pay a price equivalent to the short-run marginal cost. Suppliers to large consumers have to compete in this segment of the market.

Privatizing utilities and other natural monopolies is especially difficult in low-income countries, where private investors are few, capital markets thin, and the institutional and regulatory framework inadequate. In such instances, privatizing management is often a step in the right direction. Even where monopolies remain state owned, competitive activities can be separated out, and services provided in-house can be competitively bid for, as in Venezuela, where a private company collects tariffs for the public water company.

What, How Much, and How Fast to Sell

Most divesting governments—including Chile, Jamaica, Mexico, the Philippines, Poland, Togo, Tunisia, and the United Kingdom—began by selling small and medium-size firms that operated in competitive markets. Such sales require little prior restructuring, entail minimal political risk, are more easily absorbed by local private investors, and help prepare for subsequent sales of large and complex SOEs. The firms can and should be privatized quickly in order to put the assets to productive use. The Mexicans see this as the main lesson of their successful experience. They recommend starting with the small
firms to learn how to do it, to educate the public, and to minimize risks—in
the words of Pedro Aspe, Minister of Finance in Mexico in 1991: “If one makes
a mistake selling a night-club or a bicycle factory . . . it is not as tragic as if
these mistakes are made while selling the largest commercial bank in the coun-
try, the telephone company, or a major airline” (Aspe 1991: 8).

But there is no universal strategy. The choice of where to begin depends on
investor interest, government capacity, and which sectors and SOEs most need
new investments and improved efficiency. Some countries choose to privatize
public utilities first, despite the complexities involved. The window of political
opportunity may be open but briefly, and the most important cases may best
be tackled before conditions change. Large privatizations give the policy in-
stant credibility and send clear signals of commitment to financial markets and
investors. The potential economic and financial benefits of privatizing the util-
ities first may make it worth the risks: privatizing badly managed utilities that
provide critical goods and services can help accelerate modernization and
growth. Latin American countries (Argentina in particular) have taken this
course with good results.

Privatizing Management

A big advantage of sales over divestiture methods that do not privatize own-
ership is that sales transfer property rights to profit-oriented owners who have
an incentive to improve performance. But outright sales may not always be fi-
nancially or politically feasible, particularly in low-income countries or in en-
terprises, such as railways, water, and power, that require a big investment in
modernization. In such instances, one option is to bring in private managers
and allow the SOE to operate much like a private firm, even if the assets remain
state owned.

Management contracts have worked well in sectors such as hotels, airlines,
and agriculture, where contract negotiation and monitoring are routine and
where there is an ample supply of experienced managers. But management con-
tracts have disadvantages. Typically, contractors do not assume risk, and losses
are borne by the state. Flat fee-for-service arrangements, payable regardless
of performance, provide little incentive to improve efficiency and maintain the
value of assets (Hegstad and Newport 1987). Properly drawn contracts can
minimize these problems, but that—particularly in low-income countries—
usually requires strengthening government’s capacity to monitor and enforce
contractual obligations. Once again, the dilemma surfaces: in low-income
countries, the very factors that block privatization also impede alternative
solutions.

Leases overcome some of these drawbacks because the private party, which
pays the government a fee to use the assets, assumes commercial risk and has
more incentives to reduce costs and maintain the value of the assets. Lease
arrangements have been widely used in Africa in sectors that have difficulty
attracting private investors: water supply in Côte d’Ivoire and Guinea, power in Côte d’Ivoire, road transport in Niger, port management in Nigeria, and mining operations in Guinea (Triche 1990). The gains have been substantial. In Côte d’Ivoire, for example, the leased water company improved technical efficiency, new connections, and billing and collection of receivables—and reduced the number of highly paid expatriate staff members by 70 percent.

Concessions, in which a private operator is responsible for capital expenditures and investments as well as existing assets, are more desirable for the government but less feasible than leases because private financing (or willingness to finance) tends to fall short of the needed investment, particularly in sectors or countries where political and economic risks are high. Concessions have been successfully used in the recent telecommunication and railway privatizations in Argentina.

Analysis of the experience with private management arrangements emphasizes that governments should avoid interfering in management and should concentrate instead on accountability. SOE management can be held accountable by various mechanisms: business plans, properly staffed and empowered boards of directors, contract plans and performance agreements, and performance evaluation and incentive systems. All are costly and difficult to install; none are foolproof methods of improving performance. Managers could be given incentives to improve operations and enhance the long-term value of the assets by linking fees to performance, encouraging equity investments, or allowing managers to purchase some or all of the assets or shares when the contract or lease expires. (Obviously, this last option must not link market value at the end of the lease period with purchase price, or the lessee would have an incentive to run down the value of the enterprise.) Finally, private management arrangements are likely to work best when they are a step toward full privatization, because it is change in ownership that checks government interference and brings in badly needed investment capital.

**Full or Partial Sale?**

Selling minority shares has sometimes worked well, particularly when competition is introduced; when managerial control is transferred to competent core investors; when government’s voting rights are limited; and when the minority share offering is a prelude to a majority share offering. In Malaysia, partial sale of the port operations significantly improved behavior and enhanced productivity (Galal and others forthcoming). In Indonesia the public offering of 27 percent of equity of a state-owned cement company reportedly changed operational behavior for the better. Management reported that the need to meet listing requirements on the stock exchange led the company to hire private accountants, which improved transparency; managers also claimed that, to maintain share values, they implemented cost-cutting measures that had previously been avoided (authors’ field notes, October 1992). In Japan the sale of
33 percent of shares of Nippon Telephone and Telegraph (NTT) to 1.6 million small shareholders (with a further government commitment to sell up to 67 percent of total shares), combined with increased competition and the appointment of a new chief executive officer from the private sector, resulted in higher profits and improved service for NTT despite reduced long-distance tariffs and staff cuts of 20 percent over five years (Takano 1992).

But the NTT case also illustrates the limits of partial privatization. Most shares remain state owned, and enactment of NTT’s Corporation Law has allowed the government to remain involved in company operations—in some areas, even more than it could when NTT was a state-owned company. For example, the regulatory ministry can approve or reject appointments to the senior executive corps, even after such appointments have been approved by the shareholders’ meeting; the ministry also has the authority to approve or reject NTT’s business plan (Takano 1992).

Implementation

Once the commitment to privatize has been made and a strategy planned, the details of implementation present their own challenges to policymakers. The principal issues are the preparations needed for sale, pricing and valuation, financing, and managing the process.

Preparing for Sale

Experience shows that small and medium-size competitive SOEs can and should be sold rapidly through competitive bidding without much restructuring. But selling large enterprises requires considerable preparation, for example, legally transforming public entities into corporate forms that permit private shares (such as joint stock companies), breaking up large firms and monopolies into viable and nonviable units, separating competitive from noncompetitive activities, and identifying peripheral assets (such as real estate holdings, sports teams, and restaurants) that can be sold as separate concerns. Many such actions have been taken in the former East Germany and elsewhere in Eastern Europe and Central Asia, as well as in Argentina (railways, steel) and Mexico (steel).

Successful large privatizations—the utilities in Chile, Mexico, New Zealand, Venezuela, and the United Kingdom are examples—have also entailed the appointment of new managers, often from the private sector, with different attitudes and approaches and increased autonomy to prepare for privatization.

SOEs are typically encumbered by large debts. Private buyers are usually reluctant to take on the debt, and governments are rarely willing to discount the sale price by the amount of the debt; debt write-downs are standard practice of divesting governments the world over. Such debt relief should occur only

Sunita Kikeri, John Nellis, and Mary Shirley
when ownership and management change hands, and not before, otherwise there is a real risk that arrears will simply recur. The extent of the write-off varies. The governments of Argentina and Venezuela assumed debts of $930 million and $471 million, respectively, upon the sale of their telephone companies. In Germany government assumes, on average, 70 percent of the old debts of the companies sold.

Many SOEs have significant potential environmental liabilities, an issue particularly germane to Eastern Europe and Central Asia. Inappropriately disposed waste can be cleaned up before sale or by the purchaser as a condition of sale.

Preparation for privatization can also involve downsizing the labor force, as occurred in Argentina, Japan, Mexico, New Zealand, Tunisia, the United Kingdom, and elsewhere. Large-scale labor shedding is best handled by the state, particularly for large firms or when liquidation precedes sale of assets. Private investors would rather avoid contentious and highly visible labor disputes; and the government is better able to design social safety net measures such as retraining, severance pay, and unemployment insurance.

Some governments, in the interest of speed, have sold large firms with their labor force intact. This strategy has worked well in telecommunications and other high-growth industries able to absorb excess labor. In some instances governments have limited the latitude for private owners to make labor decisions, but such restraints have reduced investor interest (as in Pakistan, where there were twelve-month restrictions on layoffs) and have invited demands for subsidies to cover costs (as in the case of jute mills in Bangladesh). Moreover, restrictions may not be easy to enforce. As noted, in Germany the selling agency, the Treuhandanstalt, places employment maintenance clauses in the sales contracts with stiff monetary penalties for noncompliance. But these are hard to enforce because the monitoring party—the Treuhand itself—is working its way out of existence as fast as possible, and the threat of repossession lacks credibility.

Labor opposition to privatization is common, understandable, and sometimes intense—but it has been muted where employees understood that the alternative was liquidation. Campaigns to explain the costs and benefits of privatization were critical in Japan, New Zealand, Tunisia, and Venezuela—indeed, in just about every country where divestiture has succeeded. Attractive severance packages have weakened opposition and created a social safety net. In Tunisia, generous severance packages, beyond those provided by law, induced so many voluntary departures (90 percent of all redundancies) that there was little need for outright dismissals. Employee ownership schemes are useful too, although employee ownership at too high a proportion can lead to difficulties in employment and wage restructuring and make it hard to attract buyers. In Chile it has been argued that workers’ shares helped raise the price paid for SOEs because the buyers regarded the workers’ stake as reducing the risks of renationalization (see Luders 1990). The governments of Argentina, Chile,
Jamaica, Nigeria, Pakistan, Poland, Sri Lanka, and Venezuela, among others, reserved 5 to 20 percent of shares for employees at reduced prices and on easy credit terms. The benefits of the schemes were thought to outweigh the costs in lost revenue, which were usually low in the first place.

Some argue that government will get a better price for SOEs if they are physically rehabilitated before sale. But there are many reasons why most large new investments for enterprises should be left to new private owners once a decision has been made to privatize the firm. Getting the private sector to finance and manage investments and take the risk is a major reason for privatizing in the first place. There is little evidence that governments recover the costs of physical restructuring in the form of higher sales prices. And governments have found that restructuring can delay the privatization process. An exception to the rule might be long-planned and carefully vetted expansions, especially for well-run SOEs, that would be costly to delay. For example, Chile systematically planned new electricity generation projects to come on stream every few years. It would have been wasteful to delay these projects while privatizing the electricity company, and Chile did not do so.

**Pricing and Valuation**

The best way to determine the sale price is to let the market decide through competitive bidding, particularly for small and medium-size firms—as has been illustrated in Chile, the former East Germany, Mexico, and Tunisia. Even for larger enterprises, market-based pricing is preferable to technical methods, such as net asset value, net present value of discounted cash flow earnings trends (price-earnings ratios), dividend yields, or a combination of these methods. Bidders, however, must be carefully prequalified and the regulatory environment must provide incentives for modernization.

Valuation is difficult in the best of circumstances but doubly so in developing countries where macroeconomic changes are taking place; where assets have not been traded before; and where information is weak, comparables few, and the market thin. An independent valuation helps set a floor price and assure a fair process and thus provides political cover, but technical methods seldom determine the market price for an enterprise. Overvaluation and unrealistic price expectations can delay the process. Many governments base asking prices on historical book value—on the grounds that they wish to recover at least what they put in—but this has often led to valuations of eroded assets that bear little resemblance to what any buyer will offer. Conversely, if book value has not been adjusted for inflation, it may grossly underestimate market value. In the sale of the ALUNASA aluminum mill in Costa Rica, for example, the company was priced on the basis of book value at $52 million, despite persistent heavy losses. There were no takers at this price. The government then used a comparable mill in Venezuela, valued at about $8 million, as
a reference price. ALUNASA was finally sold for $4 million, about 7.5 percent of book value.

The rational economic solution for firms persistently showing losses or in a state of negative net worth is to accept any positive price offered, to give them away, or even to induce someone to take them over. Economically, it makes sense that “whenever social welfare is higher under private operations than under public operation . . . government should be willing to pay the private sector to take over the enterprise. This might happen, for instance, if the enterprise is loss-making under government operation but becomes viable under private operation without large deleterious welfare effects on consumers or workers” (Jones, Tandon, and Vogelsang 1991: 17). Although it is not common practice, the Treuhand has sold dozens of firms at the symbolic price of one deutsche mark. In these cases, according to Treuhand officials, “we are not selling companies; we are buying management and technology.”

Overpricing shares in a public offering is also a recipe for failure. In two Turkish offerings, where shares appear to have been overpriced, investors lost a total of LT450 billion (May 1991 prices) and grew wary of participating in future public offerings. In the end the Turkish government repurchased the shares to maintain the price and then resold them at later dates in smaller tranches. This was costly and set a bad precedent for the remaining public offerings. To avoid such problems, discounts on privatization sales in general have been much higher than the traditional after-market premium of 10 to 15 percent in other flotations (table 4). Gains to small investors should be viewed as a measure of success rather than as a financial loss to governments, because in such sales distributing ownership is more important than raising revenues. Prices also have to be low enough to foster demand and ensure a full subscription.

To offset potential political and financial costs, some countries sell shares in tranches. France and the United Kingdom typically started with smaller share offerings and higher discounts; as commitment was demonstrated and the confidence of the private sector increased, larger percentages were offered and discounts declined. “Clawback clauses,” used in the sale of the twelve regional electricity distribution companies in the United Kingdom, entitle the government to a share in any gains that an enterprise might make through subsequent sales of land, buildings, or other property that might be undervalued in the original sale of the enterprise.

Argentina, Malaysia, and Mexico are examples of developing countries that have sold in tranches. A case in point is the privatization of Mexico’s TELMEX (telecommunications) where the Mexican government restructured its capital so that only 40 percent of the stock had voting rights and then sold controlling shares in December 1990 by selling 20.4 percent of the company (that is, 51 percent of the voting stock) for $1.7 billion; in May 1991 a further 16.5 percent was sold for about $2.4 billion, and in May 1992 another 4.7 percent was sold for $1.4 billion. The implicit market value of the company jumped by 78 percent in five months after the first sale and more than doubled in the year
after the second sale; by selling in tranches, the government was able to reap part of these gains (Galal and others forthcoming).

Another tactic for winning political support without too large a fiscal sacrifice is to offer discounts to small investors and to ask institutional investors to pay higher prices, either fixed or by tender. Tender methods are more appropriate for sales of shares to well-informed financial institutions and trade buyers than to small investors; the former are better able to assess bid strategy and price the investment opportunity. The tender method was extensively applied in the public offerings in the United Kingdom and to all twenty-eight privatizations in Sri Lanka.

**Financing**

Government decisions often compound financing constraints brought about by weak financial systems. A surprising number of governments have put SOEs on the market at the same time that they have crowded out their SOE shares by issuing high-yield, low-risk, tax-free government bonds. Some governments have further narrowed the market by excluding the participation of foreigners or minority groups.

For political and social reasons, governments everywhere are reluctant to cede control over assets, especially those deemed strategic, to foreigners. In the

---

**Table 4. Prices for Selected Public Share Offers, 1979–87**

<table>
<thead>
<tr>
<th>Country</th>
<th>Enterprise</th>
<th>Date of offer</th>
<th>Subscription price (local currency)</th>
<th>First day closing price (local currency)</th>
<th>Premium or discount (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Compagnie Générale d’Electricité</td>
<td>5/87</td>
<td>FF290</td>
<td>FF323</td>
<td>11.4</td>
</tr>
<tr>
<td></td>
<td>Paribus</td>
<td>1/87</td>
<td>FF405</td>
<td>FF480</td>
<td>18.5</td>
</tr>
<tr>
<td></td>
<td>Saint-Gobain</td>
<td>11/86</td>
<td>FF310</td>
<td>FF369</td>
<td>10.0</td>
</tr>
<tr>
<td></td>
<td>Sogenal</td>
<td>3/87</td>
<td>FF125</td>
<td>FF225</td>
<td>80.0</td>
</tr>
<tr>
<td>Jamaica</td>
<td>National Commercial Bank</td>
<td>12/86</td>
<td>J$2.95</td>
<td>J$4.94</td>
<td>67.5</td>
</tr>
<tr>
<td></td>
<td>Caribbean Cement Co.</td>
<td>6/87</td>
<td>J$2.00</td>
<td>J$1.55</td>
<td>–22.5</td>
</tr>
<tr>
<td>Philippines</td>
<td>Philippine National Bank</td>
<td>n.a.</td>
<td>P170</td>
<td>P225</td>
<td>50.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>British Airways</td>
<td>2/87</td>
<td>125p</td>
<td>169p</td>
<td>35.2</td>
</tr>
<tr>
<td></td>
<td>British Gas</td>
<td>12/86</td>
<td>135p</td>
<td>148p</td>
<td>9.3</td>
</tr>
<tr>
<td></td>
<td>British Petroleum</td>
<td>11/79</td>
<td>363p</td>
<td>367p</td>
<td>1.1</td>
</tr>
<tr>
<td></td>
<td>British Telecom</td>
<td>12/84</td>
<td>130p</td>
<td>173p</td>
<td>33.1</td>
</tr>
<tr>
<td></td>
<td>Rolls Royce</td>
<td>5/87</td>
<td>170p</td>
<td>232p</td>
<td>36.3</td>
</tr>
</tbody>
</table>

n.a. Not available.
p. Pence.

past many states restricted external participation in privatization, thus narrowing the range of financing options (especially for large SOEs) and blocking an important source of new capital, markets, management, and technology. Many countries, such as Chile, India, and Mexico, recently have begun to relax such restrictions and instead set out to attract foreign investors by creating a stable economic and regulatory environment and guaranteeing convertibility and profit repatriation.

Political sensitivities can be allayed by reserving a "golden share" for government—that is, stipulating, in a general privatization law or in a particular sales agreement, that government retain one nonvoting special share that gives it the power to reject subsequent sale or major capital or physical restructuring of the firm. New Zealand used a variant of this arrangement in some of its privatizations, and the device is being adopted in developing countries (Argentina) and ex-socialist countries (Russia). Another device is to combine the sale of a controlling interest to a foreign investor with widespread distribution of the remaining shares to citizens and employees. In Indonesia, New Zealand, and Togo, for instance, SOEs have been sold to foreigners with the stipulation that a certain amount of shares gradually be floated to small investors through the stock market.

Foreign direct investment has been increasing since the mid-1980s. In forty developing countries it rose from 0.44 percent of GDP in 1984 to 1.15 percent in 1990. Nonetheless, in 1990 it accounted for only 10 percent of all private investment in those countries (Pfefferman and Madarassy 1992). This implies that the bulk of SOEs will have to be sold to domestic investors. Yet, governments have sometimes limited the domestic market for privatized enterprises by excluding (or favoring) certain ethnic groups. In East and South Asia commercially oriented and relatively wealthy groups of minorities are excluded, while in East Africa citizens of Asian origin are hindered or excluded. In Kenya, where privatization has been debated since the early 1980s, few sales have taken place, in part because of the sensitivities involved in dividing national assets between African citizens and those of Asian origin (the likely buyers of SOEs in any unrestricted sale). Such restrictions lead to costly delays and limit the entry of groups with the necessary capital, skills, and experience to provide jobs and opportunities for the majority. Mechanisms—such as the reservation or subsequent sale of a portion of shares for certain groups—need to be developed to mitigate political concerns and safeguard the interests of the majority, while at the same time tapping the expertise and resources of the minorities.

Regulating weak financial systems is clearly a legitimate function of government, but it should not preclude institutional investors from performing a catalytic function in financing privatization. In turn, privatization can help strengthen and diversify financial markets. After Chile encountered problems created by poor banking practices during its first sales, it was reluctant to allow banks or even private pension funds to invest in SOE shares. The government solved the problem by creating a special commission to classify the risk of these
investments—very conservatively—and by limiting the amount of high-risk shares pension funds could hold.

Sales for cash are better than accepting debt, even if this means selling at a lower price. As the experiences of Mexico and Venezuela show, outright sale cleanly severs the link between enterprise and state. Cash sales also provide the liquidity to pay enterprise liabilities and severance pay. Nevertheless, many countries have resorted to government-financed sales for debt, because financial systems are not deep enough, SOEs are not sufficiently attractive, and preferred buyers do not have enough cash. Selling on the installment plan is one option, but lowering the price, selling in tranches, or even giving small assets away may be better ways to ease financing constraints than lavish use of debt.

Highly leveraged sales, regardless of whether the seller (government) or the banks are the source of credit, are risky. In Chile many privatized firms failed between 1974 and 1984, partly because of the large debts owed to government. The initial terms were attractive. Buyers had to pay 10 to 20 percent down, with one year's grace on further payments. After that, however, they faced a short (five to seven years) repayment period, at a real interest rate of 8 to 12 percent. The firms had a very thin equity cushion when the recession hit in the early 1980s; seven of every ten privatized companies went into bankruptcy and reverted to state hands when their controlling banks were nationalized. In the second round of sales, the chastened government gave no credit (except to the smallest investors and employees), and bidders had to prove their solvency (Hachette and Luders 1988).

Debt-equity swaps can ease financing constraints and help improve a country's investment climate. In a swap the debtholder who wants to buy the enterprise exchanges debt—worth a fraction of its face value in the secondary market—for equity. Usually, the debt trades at a rate better than the secondary market price but still well below the face value. Swaps have been a way for heavily indebted countries such as Argentina, Chile, and the Philippines to bring foreign investors, including commercial banks, into transactions that might not have been concluded without their participation (Sung 1991). In Argentina swaps in privatizations reduced the face value of outstanding commercial bank debt by 20 percent.

Critics of swaps argue with some justification that governments may be better off selling the enterprise and using the proceeds of the sale to repay or re-purchase the debt on the secondary market, as Mexico has done. That way they might capture more of the discount and expand the participation of local investors. This approach is appealing, but it has its limits: while Mexico's participation in the Brady plan put it in a good position to attract investors, a large debt overhang may deter foreign or domestic investors from buying SOEs, particularly large companies that require new investment. Thus, in heavily indebted countries, debt-equity swaps can be useful—although paradoxically, the more successful debt-equity swaps are, the more their usefulness declines. As a country buys its debt back, it becomes a better credit risk; the secondary
market discount on the debt drops, and this reduces the incentive for the in-
vestor. (This was one reason why the volume of Chile's swaps dropped from
$1.9 billion in 1989 to $0.7 billion in 1990.) Swapping public debt for private
equity raises issues, such as the effect on inflation and government borrowing
requirements, that go beyond the scope of this article.

Managing Privatization

Transparency, essential in every privatization, requires competitive bidding
procedures, clear selection criteria for evaluating bids, disclosure of purchase
price and buyer, well-defined institutional responsibilities, and adequate mon-
itoring of the program. A lack of transparency can lead to suspicions of unfair
dealing (founded or unfounded) and to a popular outcry that can threaten not
only privatization but reform in general.

But zeal for transparency should not become an excuse for inaction. For
small competitive firms, all that is normally needed is light supervision and re-
view of transactions; Mexico and the former East Germany, for example, di-
vested hundreds of enterprises in this way. Small business units can be divested
even more quickly, as the experience of the former Czechoslovakia, Germany,
Hungary, Poland, and Russia shows. But the larger and more visible the trans-
action and the less competitive the market for the enterprise's goods or servic-
es, the greater the importance of transparency.

Both transparency and speed are served by centralizing policy responsibili-
ties for privatization in a strong unit created for the purpose rather than in
cabinet commissions and sector ministries. The latter tend to create delays,
because of vested interests, and make the process less transparent. The privatiza-
tion authority should answer to the top of the political hierarchy, have a clear
mandate and authority, and have a small but highly competent staff. In the
second privatization phase in Mexico, a unit of seven people in the Ministry
of Finance, reporting directly to an interministerial commission of key minis-
ters and freed of public sector rules and regulations, divested hundreds of en-
terprises within a few years. In the Philippines the Asset Privatization Trust,
headed by a qualified private businessman and staffed by a small group of ex-
perienced private individuals paid at private sector rates, disposed of more than
150 nonperforming assets in two years.

Although decisionmaking is best centralized, the process can be accelerated
and the workload of the unit in charge reduced by decentralizing implementa-
tion. Specific tasks can be delegated to banks and financial institutions (as was
done in France, Mexico, and Nigeria), to international and local business con-
sultancies (as in Argentina and Venezuela), to holding companies (as in Egypt
and the Philippines), and to SOE managers themselves (as in the former
Czechoslovakia, Hungary, Russia, Tunisia, and Turkey). The privatization au-
thority must supervise these implementing agencies and provide a clear time-
table for privatization; otherwise, the risk of inaction or abuse is great. Clear
standards of accountability are also necessary to minimize fraud and ensure transparency.

Government capacity to handle the privatization process is scarce; time and money have to be spent obtaining the right technical, financial, and legal skills. Small privatizations can and should be handled locally to the extent possible (as in Mexico), but skills may need to be imported for large transactions and in the least developed countries, where institutional weakness has substantially delayed privatization.

The lesson that ownership matters has been heeded: increasingly, governments worldwide are moving to tap private management and finance and to privatize. The evidence indicates that—as long as it is done right—privatization can and does bring efficiency and needed innovation. The lessons drawn from the experience with privatization offer some guidance on how to realize the potential while minimizing the costs.

Notes

Sunita Kikeri and John Nellis are with the Private Sector Development Department and Mary Shirley with the Policy Research Department at the World Bank.

1. This is a conservative estimate of the number—difficult to calculate—of SOEs privatized as of mid-1993. The net reduction in SOEs worldwide is even harder to determine. Some states have been creating SOEs, while others have been divesting (Burundi, for example); and there are cases (Ghana, for example) where privatized firms ran into difficulties and have found their way back into the state’s portfolio for a perhaps temporary, perhaps indefinite stay.

2. Lobbying by the private sector would persist, of course. Moreover, it must be admitted that some firms in every economy seem “too big to fail” and that in some countries the public-private distinction is quite blurred and a policy of “first privatize the private sector” should be followed. Nonetheless, the sentence footnoted is more often correct than not.

3. Under other circumstances there may be reasons why the private owner may not invest in a privatized utility, as cited by Sappington and Stiglitz (1987). See also Levy and Spiller (1994) on problems of commitment and private investment in utilities.

4. These numbers would be much higher if they included the very large number of completed “small” privatizations of shops, microenterprises, and kiosks in the retail and services sectors. As of mid-1993 an estimated 80,000 such firms had been privatized in Poland alone, 7,000 in Czechoslovakia, 1,100 in Hungary, 13,000 in the former East Germany, and 200,000 in Russia. The numbers also predate the major privatizations in Argentina. Also excluded are the mass restitutions of property to former owners in Chile and the privatization of small enterprises (mostly jute mills) in Bangladesh.

5. Unless otherwise designated, dollar figures represent U.S. dollars throughout.

6. Share ownership reconcentrates despite the mechanisms used to attract and retain small shareholders (such as bonuses or matching shares, pricing discounts, and reduced taxes on dividends). In the United Kingdom ownership quickly reconcentrated. Similarly, at the time of the public issue of the Malaysian International Shipping Corporation, there were approximately 60,000 shareholders; the number fell to fewer than 5,000 after a brief round of secondary trading. Similar patterns have emerged in other countries divesting through their stock markets (see Adam and Cavendish 1990).
The word “processed” describes informally reproduced works that may not be commonly available through library systems.


Sunita Kikeri, John Nellis, and Mary Shirley


